DIRECTORS' AND OFFICERS' LIABILITY

HOW COMPLETE IS SLUSA PREEMPTION?

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The recent surge in filings of state law claims for damages arising from "owning and holding" securities is of great interest to directors and officers, and their insurers. Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") with the stated goal of closing a "federal flight" loophole in the Private Securities Litigation Reform Act of 1995 ("PSLRA"), thereby prohibiting evasion of the PSLRA's heightened requirements by disclaiming federal relief and bringing suit in state court under state statutory or common law. In recent months, the debate about whether SLUSA preempts only private suits by actual purchasers or sellers of securities, or whether the statute's broad preemptive reach also bars state law forbearance claims for "owning and holding" securities has intensified and may be headed to the Supreme Court.

SLUSA Overview

The PSLRA was enacted to curb perceived abuses in private securities fraud lawsuits, most prominently the commencement of non-meritorious class actions in the hope of extracting a settlement. By 1998, it became apparent to Congress that certain plaintiffs were frustrating the objectives of the PSLRA simply by migrating securities class actions from federal court to state court, and recasting a securities claim as a breach of contract, negligent misrepresentation, common law fraud or breach of fiduciary duty.[1] SLUSA was enacted to halt the diaspora. By displacing any state law claim that falls within its scope, SLUSA seeks to ensure that securities fraud cases are heard only in federal court and only under a uniform standard prescribed by federal law if five criteria are satisfied: (1) the lawsuit is a "covered class action;" (2) the claim is based on state statutory or common law; (3) the claim concerns a "covered security;" (4) the plaintiff alleges a "misrepresentation or omission of a material fact;" and (5) the misrepresentation or omission is made "in connection with the purchase or sale of a covered security."[2] Preemption ordinarily is an affirmative defense, entertained by the court in which the plaintiff chose to sue. SLUSA departs from the norm; if a case meeting the criteria is filed in

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state court, it is removable to the federal court for the district in which the action is pending and subject to dismissal there.[3] The claim labels and pleading techniques used by plaintiff are not controlling; courts look to the substance of the allegations to determine if they trigger preemption.[4]

Confusion Over "In Connection With"

SLUSA does not define the meaning of "in connection with the purchase or sale" of a covered security. Because section 10(b) of the Securities Exchange Act employs the same language, courts have uniformly followed interpretations of section 10(b) when interpreting "in connection with" under SLUSA.[5] The Supreme Court has adopted a broad interpretation of the language, insisting only that there be some nexus between the alleged fraud and a securities transaction.[6]

In addition to satisfying the statutory "in connection with" requirement, a private section 10(b) claimant must meet a prudential requirement. In *Blue Chip Stamps v. Manor Drug Stores*,[7] the Supreme Court held that a private plaintiff lacks standing to seek damages under Section 10(b) unless a challenged misrepresentation or omission caused the plaintiff actually to buy or sell a particular security, even if failure to purchase or sell was the result of fraud. A shareholder who is induced by a material misrepresentation or omission merely to continue to hold stock thus has no standing to sue under section 10(b). The purchaser-seller standing requirement "limit[s] private actions to harms arising out of actual trading, which narrows the affected class and simplifies proof, while leaving other securities offenses to public prosecutors."[8]

Since the enactment of SLUSA, a growing number of plaintiffs have sought to define non-purchaser-non-seller securities classes in order to avoid SLUSA, and litigate in state and federal court state law "holder" claims which could not be brought under the federal securities laws. These claims typically allege that the defendant wrongfully induced non-trading shareholders to continue holding stock, resulting in damages in the diminished value of the stock held during the class period.

The early circuit authority concluded that SLUSA did not preempt state law claims that were not brought on behalf of purchasers and sellers. In *Riley v. Merrill Lynch*,[9] the Eleventh Circuit stated that "under *Blue Chip*, SLUSA does not apply to claims dealing solely with the retention of securities, rather than with purchase or sale," but offered a qualification that SLUSA does preempt claims alleging that misrepresentations and omissions caused class members both to purchase *and* retain securities: "[A] plaintiff may not avoid SLUSA's restrictions simply by alleging that a given misrepresentation caused him both to purchase and hold a particular security."

Similarly in *Green v. Ameritrade, Inc.*,[10] the Eighth Circuit held that "in enacting SLUSA, Congress did not make class actions on behalf of 'nonsellers' and 'nonpurchasers' removable to

federal court." Plaintiff sued Ameritrade for breach of contract in state court, alleging that Ameritrade had breached a contractual obligation to afford him "real time" stock quotes from Ameritrade's web system. Ameritrade removed under SLUSA, arguing that the suit really involved misrepresentations made "in connection with the purchase or sale of a covered security" because consumers typically use the price information provided by a real-time quote service to purchase and sell securities. The court affirmed a remand to state court on the ground that the claim was simply for breach of contract, and not "in connection with the sale or purchase of a covered security." "So long as his state-law claim does not require him to prove there was a sale or purchase of a covered security in reliance on the misrepresentation," the court stated, SLUSA preemption is inapplicable.

This year, the Second Circuit tackled whether SLUSA preempts holder claims in *Dabit v. Merrill Lynch,*[11] in which a former Merrill broker filed a complaint in Oklahoma federal court under diversity jurisdiction on behalf of a purported class of Merrill brokers who owned and held securities recommended by the firm. The complaint alleged state law claims, contending that Merrill had issued misleading research and recommendations concerning certain securities to attract investment banking business, and that defendant's purported misconduct damaged the class as a result of, *inter alia*, their owning recommended stocks. The MDL Panel transferred the case to the Southern District of New York, where it was dismissed as preempted by SLUSA.

The Second Circuit reversed, holding that to be preempted an action must allege a purchase or sale in reliance on the defendant's alleged misconduct because SLUSA only preempts claims "capable of being brought under federal law." Rejecting the position of Merrill and the SEC (whose views the court solicited), the court held that "the purchaser-seller rule affirmed in *Blue Chip* applies to the construction of 'in connection with' under SLUSA," reading the legislative history of SLUSA to suggest that SLUSA "preempt[s] precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA." "If it were otherwise," the court reasoned, "actions might be preempted for meeting all of SLUSA's requirements, including the 'in connection with' term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5."

The court noted, however, that the proposed holder class defined in the complaint did not exclude purchasers and therefore was preempted by SLUSA. A "plaintiff who alleges the purchase and retention of securities in reliance on the misrepresentation but who forswears *damages* from the purchase and seeks only 'holding damages' has still run afoul of SLUSA." If it is not clear from the complaint that purchasers and sellers are excluded, the court concluded "that the proper approach will ordinarily be to dismiss the entire claim pursuant to SLUSA . . . . without prejudice in order to allow the plaintiff to plead a claim sounding only in state law if possible," the course taken in *Dabit*. Merrill has filed a petition for a writ of certiorari in *Dabit*.

In an opinion authored by Judge Easterbrook in April, the Seventh Circuit rejected the Second Circuit approach, presenting an undeniable conflict for the Supreme Court. The Seventh Circuit broadly held in *Kircher v. Putnam Funds Trust,*[12] that "SLUSA is as broad as §

10(b) itself and that limitations on private rights of action to enforce § 10(b) and Rule 10b-5 do not open the door to litigation about securities transactions under state law." Mutual fund investors filed state law putative class action claims in state court alleging that the fund and its investment adviser had engaged in misconduct that reduced the value of their shares. Plaintiffs defined a purported class of all investors who held the fund's securities during a defined period *and* neither purchased nor sold shares during that period. Clearly, *Blue Chip* would bar a class so-defined from proceeding under Section 10(b). Under the analysis of the Second, Eighth and Eleventh Circuits, this would conclude the SLUSA analysis and compel remand to state court, which is what the district court did.

But the Seventh Circuit rejected "[a]n equation between SLUSA's coverage and the scope of private damages actions" under Section 10(b). Offering an argument elegant in its simplicity, Judge Easterbrook explained that "[t]o say that SLUSA uses the same language as § 10(b) and Rule 10b-5 is pretty much to resolve the point." He noted that "Section 10(b) defines a federal crime, and it also permits the SEC to enforce the prohibition through administrative proceedings. Invocation of this anti-fraud rule does not depend on proof that the agency or United States purchased or sold securities; instead the 'in connection with' language ensures that the fraud occurs in securities transactions rather than some other activity." Stated another way, plaintiffs' decision to define their classes as containing only holders did not foreclose § 10(b)'s application to their allegations through public enforcement, but it did foreclose private suit under that provision. Judge Easterbrook observed that *Blue Chip* does not suggest that § 10(b) applies only when the plaintiff itself traded securities. Rather, it reflects the Supreme Court's recognition that the private right of action to seek damages under Section 10(b) is a judicial creation, and its determination "to confine these actions to situations where litigation is apt to do more good than harm." "It would be more than a little strange," he concluded, if the purchaser-seller limitation on the ability to sue "became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all." The court reversed the remand and instructed the district court to dismiss plaintiffs' state-law claims.

Conclusion

The imposition of the *Blue Chip* purchaser-seller standing requirement as a limit on the preemptive reach of SLUSA is inconsistent with the text and intent of SLUSA, and conflates the issue of standing with the statute's "in connection with" requirement. The Seventh Circuit's ruling that SLUSA's "in connection with" language does not incorporate the purchaser-seller requirement correctly casts *Blue Chip*'s standing limitation as based, as the Supreme Court has said several times including in *Blue Chip* itself, primarily upon prudential considerations.[13] If the purchaser-seller requirement in fact were part of the statute's "in connection with" language, then the SEC and the U.S. would be barred from bringing civil and criminal enforcement proceedings.

Holder claims fall squarely within SLUSA preemption because they necessarily allege damages flowing from misrepresentations or omissions "in connection with the purchase or sale of a covered security." The price of the non-transacting holder's shares is adversely affected by the same alleged "in connection with" wrongdoing that artificially inflates the stock price through trades made by purchasers and sellers during the same period. Moreover, most holder claims (like purchaser-seller claims) require a showing of loss causation through a corrective disclosure relating to a prior misrepresentation that results in a price decline. As the Supreme Court recognized this term in *Dura Pharm., Inc. v. Broudo*,[14] loss causation will not arise unless a decline following the corrective disclosure is effected through purchases and sales of the relevant security.

Dabit presents an important and recurring issue, and an unusually compelling candidate for Supreme Court review, because most of the circuits to consider the issue, including the Second Circuit, have held that orders remanding cases removed under SLUSA, erroneous or not, are not reviewable.[15]

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[1] *Spielman v. Merrill Lynch*, 332 F.3d 116, 122-24 (2d Cir. 2003).

[2] 15 U.S.C. § 78bb(f)(1)(A).

[3] 15 U.S.C. § 78bb(f)(1)-(2).

[4] *Dabit v. Merrill Lynch,* 395 F.3d 25, 34 (2d Cir. 2005); *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879 (8th Cir. 2002).

[5] *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 292 F.3d 1334 (11th Cir. 2002); *see also Dabit v. Merrill Lynch,* 395 F.3d 25, 34-36 (2d Cir. 2005); *Rowinski v. Salomon Smith Barney Inc.,* 398 F.3d 294, 299 (3d Cir. 2005); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597-98 (8th Cir. 2002).

[6] *See SEC v. Zandford*, 535 U.S. 813, 819 (2002).

[7] 421 U.S. 723, 727 (1975).

[8] *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005).

[9] 292 F.3d 1334 (11th Cir.), *cert. denied*, 537 U.S. 950 (2002).

[10] 279 F.3d 590 (8th Cir. 2002).

[11] 395 F.3d 25 (2d Cir. 2005).

[12] 403 F.3d 478 (7th Cir. 2005).

[13] *See U.S. v. O'Hagan*, 521 U.S. 642, 664 (1997); *Holmes v. Securities Inv. Prot. Corp.*, 503 U.S. 258, 284 (1992) (O'Connor, J) (concurring); *Blue Chip*, 421 U.S. at 737-38.

[14] 125 S. Ct. 1627 (2005).

[15] *Spielman v. Merrill Lynch*, 332 F.3d 116 (2d Cir. 2003).